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Article

Tips to win your personal battle with the taxman

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As we approach the end of another tax year it seems appropriate to point out that a precursor to the modern income tax was invented by Britain in 1800 to finance the Napoleonic Wars. The tax was repealed in 1816 and opponents of the tax, who thought it should only be used to finance wars, wanted all records of the tax destroyed along with its repeal. Two centuries later, the fiscal challenges facing the Government mean that tax policy remains controversial. Interest will continue to increase in the period up to 6 April as we all look at ways to reduce or mitigate our income tax. This tax year has seen a number of important changes to the rules governing how we save and take benefits from a pension. Careful planning is needed to ensure that we get the balance right between exploring opportunities and understanding the risks.

Taking your tax-free lump sum from age 50?

Today's rules provide that the minimum age for most individuals to take a tax-free lump sum and pension is 50. With effect from 6 April 2010, this minimum age is increasing to 55. If you are aged between 50 and 54 on 6 April 2010 and you have not crystallised or taken all of your retirement benefits you will not be able to take any more until your 55th birthday. If you are planning to utilise your pension fund for a holiday to lift your mood after the coldest winter for 48 years, to reduce debt or to ease money worries time is running out.

Taking up to 25 per cent of your pension fund as a tax-free lump sum will mean the balance must then be used to provide an income in the form of an annuity or income drawdown. Under income drawdown, after taking the tax-free lump sum you can set your income to zero so that the balance of your fund remains invested until a later date.

The decision to take your retirement benefits early should not be taken lightly. Taking benefits early can seriously damage the future growth and therefore income potential of your pension fund. You must also remember that taking up to 25 per cent tax-free cash removes that money from an environment where it grows free of UK income and capital gains tax. Equity markets have been volatile over recent years, the value of your fund and tax free cash entitlement could have suffered as a result of this. As a rule of thumb, you should only take benefits where there is a genuine need to access the fund early and no other options exist. If you decide that you would like to benefit from your tax free cash early there are other points you need to consider.

Is it an employer sponsored pension scheme?

You will need to check with your employer whether this is possible as the structure and benefit process of company pension schemes varies significantly.

Do you plan to re-invest the benefits taken back into a pension?

The Government introduced rules in April 2006 to prevent tax-free lump sum "recycling". This is where you look to boost your pension savings by taking the tax-free lump sum and reinvesting the proceeds into a pension plan to gain more tax relief. The penalty for recycling could be a tax charge of up to 70% of the tax-free lump sum.

Are you already in receipt of benefits from an income drawdown plan?

Taking further pension benefits may lead to a review of the maximum income that can be taken from the existing income drawdown plan. This can lead to a drop in maximum income where your pension fund and or the gilt rate used to calculate income has fallen.

Do you plan to consolidate a number of existing pension arrangements to allow you to take benefits?

If transfers are being made from other schemes before benefits are taken then it is important to start the process in good time. The time taken to complete transfers varies across providers from a few weeks to many months. Penalties may also be applied if you transfer out of an older style pension.

Pension providers will be busy as requests for benefits increase

It is likely that pension providers will receive a significant number of requests for benefit payments in the run up to the change in minimum pension age. If your tax-free cash is needed for a particular reason it is important to start the process at the earliest possible time.

Thinking of making a pension contribution?

Of course, whether you are taking benefits or not, you may be considering paying a contribution before the end of the tax year. For the vast majority of people, paying pension contributions is a highly tax efficient way to save for your retirement. Recent changes add a great deal of complexity to this area for high earners. The Government has introduced measures to restrict tax relief on pension contributions paid by those earning over £130,000. What are known as “anti-forestalling” measures were introduced to prevent higher earners maximising their tax relief in the period up to 6 April 2011. To determine whether these new rules apply, you need to calculate what is known as “relevant income”.

This is a complex calculation bringing into play previous tax years, all of your taxable income, not just your earnings, plus any contributions made under salary sacrifice, less personal contributions to a maximum of £20,000.

You must fully explore whether these new rules impact you. However, for many there are a number of common action points you may need to consider.

If your relevant income is above £130,000, you may consider paying contributions up to a £20,000 figure known as the special annual allowance. This buffer zone disappears in 2011. If your relevant income is currently less than £130,000 but it may be higher in the future, you may consider maximising contributions while you can benefit from higher rate tax relief on contributions above the £20,000 limit. If paying a personal contribution will bring your relevant income below £130,000, consider making the contribution. If you don’t bring this year’s relevant income figure to less than £130,000 this will restrict your ability to pay a contribution next year.

In any tax strategy it is always wise to avoid use of terminology that involves war. However, with the financial conditions being the toughest in memory, it does sometimes feel a little like a case of let the battle commence.

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Please note this document is intended for trade and national press individuals.

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